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No. 92-1941

In The

Supreme Court of the United States

October Term, 1993

UNITED STATES OF AMERICA,

Petitioner,

v.

JERRY W. CARLTON, EXECUTOR OF THE WILL OF WILLAMETTA K. DAY,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Can the government enact a new estate tax deduction to induce executors to sell estate assets at a discount to an employee stock ownership plan and, after a taxpayer has done so, retroactively impose additional, unforeseeable conditions and deny the deduction?

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[1] The appendix attached to the Solicitor General's petition contains four items, identified as Appendices A-D, and concludes with page 46a; to reduce the likelihood of confusion, the two documents appended to this brief are identified as Appendices E and F and begin with page 47a.

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STATEMENT OF THE CASE

In 1984, the Senate proposed an estate tax deduction for one-half of the proceeds of an executor's sale of an employer's stock to its employee stock ownership plan ("ESOP") completed before the deadline (including extensions) for filing a federal estate tax return. *See, e.g.*, Appendix, Petition for Writ of Certiorari, 21a; Appendix, *infra*, 49a (hereinafter "App., 21a" and "App., 49a," respectively); 2 Senate Comm. on Finance, 98th Cong., 2d Sess., *Statutory Language of Provisions Approved by the Committee on March 21, 1984*, 338-40 (S. Prt. 98-169). Although not enacted as a part of the 1984 tax legislation affecting

ESOPs, a similar provision was enacted effective October 22, 1986 and codified as Section 2057 of the Internal Revenue Code. Tax Reform Act of 1986, Pub. L. No. 99-514 ("TRA"), §§ 1172(a), (c), 100 Stat. 2085, 2513-15 (1986) (amended 1987; repealed 1989).[2] Between the time

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[2] As enacted, the statute provided, in relevant part:

"SEC. 2057. SALES OF EMPLOYER SECURITIES TO EMPLOYEE STOCK OWNERSHIP PLANS. . . .

"(a) GENERAL RULE. – For purposes of *the tax* imposed by section 2001, the value of the taxable estate *shall be determined by deducting* from the value of the gross estate *an amount equal to 50 percent of the qualified proceeds of a qualified sale* of employer securities.

"(b) QUALIFIED SALE. – For purposes of this section, the term *'qualified sale' means any sale of employer securities by the executor of an estate to* –

"(1) *an employee stock ownership plan* is [sic] described in section 4975(e)(7). . . .

"(c) QUALIFIED PROCEEDS. – For purposes of this section –

"(1) IN GENERAL. – The term *'qualified proceeds' means the amount received* by the estate from the sale of employer securities at any time *before the date on which the [estate tax] return . . . is required to be filed (including any extensions).*

"(d) WRITTEN STATEMENT REQUIRED. –

"(1) IN GENERAL. – *No deduction shall be allowed* under subsection (a) *unless the executor* of the estate of the decedent *files* with the Secretary the statement described in paragraph (2).

"(2) STATEMENT. – A statement is described in this paragraph if it is *a verified written statement of* –

"(A) *the employer* whose employees are covered by the plan described in subsection (b)(1) . . .

"consenting to the application of section 4979A with respect to such employer or cooperative." (Emphasis added.)

Congress passed the TRA on September 25, 1986 and its adjournment on October 18, 1986, Congress considered a large number of potential technical and clerical corrections to the TRA and made several changes to it. No bill or resolution was introduced, however, that would have added any condition to the availability of the new estate tax deduction beyond those contained in the statute itself. (App., 3a-4a, 48a-49a.)

Respondent, Jerry W. Carlton as executor of the will of Willametta K. Day (the "executor" and "Mrs. Day" respectively), reviewed the provisions of the TRA, its amendments, and the possible amendments to it proposed before Congress adjourned and determined that it was in the estate's financial interest to avail itself of the new estate tax deduction (App., 50a). The executor purchased 1,500,000 shares of MCI Communications Corporation ("MCI") stock on December 10, 1986 for an average price of $7.47 per share and a total purchase price of $11,206,000 (App., 4a, 50a). Although the executor had determined that the trustee of MCI's ESOP might be interested in acquiring some MCI stock, the executor had no advance agreement to sell the stock to the ESOP and, thus, bore the risk of loss if the market for the stock were to decline or if the executor had to sell it back to a market-maker for less than the purchase price (App., 4a, 50a). On December 12, 1986 the trading price for MCI stock ranged from $7.125 to $7.50, and the executor entered into an agreement to sell the stock to the ESOP for $7.05 per share (26 cents per share below the mean trading price), for a total sale price of $10,575,000 (App., 4a-5a, 50a). In accordance with Section 2057, the executor obtained MCI's agreement to the application of 26 U.S.C.

§ 4979A (Supp. IV 1986) (amended 1989) to MCI (as required by Section 2057(d)) and obtained an opinion from its general counsel that its ESOP was a plan described in 26 U.S.C. § 4975(e)(7) (Supp. IV 1986) (amended 1990) (as required by Section 2057(b)(1)) (App., 51a; n.2, *supra*). On December 17, 1986, the sale was consummated (App., 51a).

The executor would *not* have purchased the stock at its then prevailing price of about $7.47 per share and sold it to the ESOP at a discounted $7.05 per-share price (and incurred incidental transaction costs) but for the new estate tax deduction; similarly, the ESOP would *not* have been able to purchase the stock at the discounted price if the executor had not expected to receive the estate tax deduction (App., 5a, 51a).

On December 29, 1986, the executor timely filed Mrs. Day's federal estate tax return, claiming a deduction for 50 percent of the proceeds of sale of the MCI stock and paying $18,752,250 in estate tax (App., 5a, 51a).

In January 1987, the Internal Revenue Service ("Service") announced that "[p]ending the enactment of clarifying legislation," the Service would *not* recognize the deduction permitted under Section 2057 (1) unless a decedent "directly owned" the securities before death and (2) unless the securities were allocated or held for future allocation *by the plan* in particular ways[3] (App., 51a-52a;

[3] In general, the 1987 changes (a) require that the ESOP immediately allocate the securities to participants' accounts or hold them for future allocation in accordance with rules that apply in other contexts and (b) preclude the ESOP from substituting the securities or other employee stock already held by the ESOP.

Notice 87-13, 1987-1 C.B. 432, 442). Neither of those requirements was contained in the TRA, and neither was identified in the hundreds of technical and clerical amendments proposed before Congress adjourned (App., 5a, 52a). Moreover, there had been no prior notice from the Service that it would seek "clarifying legislation" (App., 17a).

In December 1987, Congress enacted legislation to impose these two additional requirements retroactively to the date that the statute was originally effective – as well as making a number of other changes effective for sales made after February 26, 1987, the date of introduction of the 1987 legislation (App., 5a-7a, 52a-53a; Omnibus Reconciliation Act of 1987, Pub. L. No. 100-203, § 10411, 101 Stat. 1330-432 to 1330-433).

When the Service audited Mrs. Day's federal estate tax return, it disallowed the claimed ESOP-proceeds deduction[4] and denied the executor's claim for refund after the executor paid the deficiency assessed (App., 53a-54a). Plaintiff then instituted this refund action in the district court. Although the district court held for the government (App., 42a), the Ninth Circuit reversed and remanded with instructions to enter judgment for the executor (with Judge Norris dissenting) (App., 25a). Thereafter, the Ninth Circuit denied the government's

[4] The Service asserted a deficiency of $3,385,333 as a result of the audit. The net deficiency attributable to the ESOP-proceeds deduction was $2,501,161. The executor does not dispute the remaining deficiency (App., 7a, 54a).

petition for rehearing and rejected its suggestion for rehearing en banc (App., 37a).

REASONS FOR DENYING THE WRIT

The writ should be denied, because (a) this case turns on the analysis of the particular facts involved, (b) there is no conflict between the Ninth Circuit's analysis and application of established constitutional principles in this case and the decisions of this Court and other decisions of the Court of Appeals, (c) the case was properly decided, and (d) the Ninth Circuit's narrowly-written decision involving a now-repealed statute will not hamstring the government in the administration of the revenue laws.

I. THE NINTH CIRCUIT DECISION TURNS ON THE ANALYSIS OF FACTS UNIQUE TO THIS CASE.

The disparity between the statement of the question presented in the Solicitor General's Petition for Writ of Certiorari ("Petition") and in this brief reveals the basic reason for denying the writ. In large measure, the Petition is a quarrel with the conclusion of law by the majority of the Ninth Circuit panel (the "majority") that the executor did not have constructive notice of the future imposition of the additional restrictions on the ESOP-proceeds deduction that the 1987 legislation purports to apply. The Solicitor General's arguments that retroactive application is consistent with this Court's traditional analysis under the Due Process Clause (Petition, 11-17) and that the majority announces "a new and unsupported method of due process analysis" (Petition, 11, 17-23) are premised on his view that the executor had constructive notice of "curative" legislation to "close a loophole" and "avert potential abuse" (Petition, 14-20). Similarly, the egregious impact of the decision on the "routine enforcement of the federal revenue laws" and the "insurmountable obstacles" it will impose on "reasonable legislative action" that the Petition postulates (Petition, 11, 24) conceivably could follow only if one accepts the Solicitor General's version of the facts. If one accepts the facts stipulated in the trial court (App., 47a-54a) and the one determined by the majority as a matter of law (App., 17a-18a, 33a-35a), however, its decision is both unremarkable and correct.[5]

In this case, the government has stipulated that: (a) the decedent ownership requirement was not contained in Section 2057 as initially enacted (App., 5a, 52a); (b) it was not contained in any amendment to the statute passed by the Congress before the executor made his below-market sale to the ESOP and filed his estate tax return (App., 5a, 52a); (c) it was not contained in any of the hundreds of potential technical and clerical amendments to the statute considered before the Congress adjourned (App., 3a-5a, 48a-49a, 52a); and (d) "[n]o bill or

[5] Contrast the facts of this case with those in *Ferman v. United States*, 993 F.2d 485 (5th Cir., June 18, 1993) (a copy of which is attached to this brief as Appendix F), where most of the ALZA stock was purchased about six weeks *after* the advance release of the Notice and was subject to a prior agreement that the ESOP would, in turn, purchase the stock (App., 58a, 61a-62a, 70a-71a); here, the executor acted several weeks *before* advance issuance of the Notice and had no advance agreement with the ESOP (App., 4a, 50a).

resolution was introduced that would have added any condition to the availability of the new [s]ection 2057 deduction other than those contained in the statute itself during the period between the passage of the [1986 legislation] and the adjournment [of Congress] on October 18, 1986" (App., 4a, 49a).[6]

After a thorough review of the government's arguments, the majority concluded that "no act of the executive or legislative branch would have given any forewarning of the 1987 amendment at the time the MCI ESOP transaction occurred" (App., 17a-18a).

Assuming, *sub silentio*, that this Court may be disposed to review the majority's conclusion as part of the Court's review of the application of constitutional principles to the facts of the case at bar, the Solicitor General relies on four bases to advance the proposition that the executor did have constructive notice that the statute would be amended to include the restrictions that the Solicitor General seeks to apply retroactively. None of these is persuasive.

(a) The Solicitor General first asserts "that every taxpayer is deemed to have constructive notice of the possibility of changes in the provisions of existing tax

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[6] In view of the multitude of proposed amendments to the TRA considered before adjournment of the 99th Congress (one of which dealt specifically with Section 2057) and the changes enacted to it by the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (App., 3a-4a, 48a-49a), Congress did not act to amend the new section 2057 "at the first opportunity" as the Solicitor General now contends (Petition, 23).

laws" (Petition, 18). The majority aptly observed that this Court's carefully reasoned analysis in *United States v. Hemme*, 476 U.S. 558 (1986), and *United States v. Darusmont*, 449 U.S. 292 (1981) (*per curiam*), would have been unnecessary if there were a *per se* rule that tax statutes can *always* be retroactively applied so long as they do not enact a "wholly new" tax (App., 10a).

(b) The Solicitor General then contends that the history of the 1986 legislation should have forewarned the executor (Petition, n.13). He refers to a 1985 pamphlet reviewing legislative proposals concerning ESOPs published by the staff of the Joint Committee on Taxation and to a 1986 floor statement by Senator Long. As noted by the majority, "[b]oth of these references merely state that the ESOP-proceeds deduction would be *available* to a decedent who sold his company to an employee group. The government can point to no place in the legislative history that states that the ESOP-proceeds deduction would be *limited* to such a situation" (App., 18a). The majority also noted that omitting a decedent-ownership requirement from the ESOP-proceeds deduction could not be attributed to a "last-minute drafting error," because the deduction had been under consideration for over two and one-half years before it was enacted (App., 21a, 49a).

(c) The Solicitor General next contends that the deduction as originally enacted was "too good to be true" and that the executor should have anticipated a retroactive restriction or restrictions that would preclude his qualification for the deduction (Petition, 20, 23). As noted by the majority, this argument is unavailing for at least three reasons.

(1) The executor was justified in relying on the plain language of the statute, which contained no suggestion of the decedent ownership or allocation-by-the-ESOP-after-acquisition requirements. Just as this Court relies on the plain language and meaning of statutes in interpreting them, taxpayers are entitled to do the same. As the majority put it, "[w]e flatly reject the government's premise that a taxpayer cannot rely on the clear and unequivocal text of the Tax Code, but instead must speculate on the unspoken and inchoate intentions of Congress" (App., 19a-20a).

(2) Particularly when placed in the context of other uses of the tax law to encourage the funding of ESOPs, there is nothing particularly surprising about the absence of a decedent-ownership requirement. As explained by the majority,

> Congress has given several substantial tax incentives to ESOPs over the years. When a bank loans money to an ESOP to finance the purchase of shares, half of the interest income from such loans is excluded from taxable income. *See* 26 U.S.C. § 133. Taxpayers who sell shares to an ESOP may defer for tax purposes the recognition of any capital gain on such sale. *See* 26 U.S.C. § 1042. In this context, section 2057's provision allowing half of the proceeds of a sale of shares to an ESOP to be excluded from the taxable estate would not have appeared out of line.

(App., 21a.) Logically, there is no reason for a decedent-ownership requirement, because the goal of the Section 2057 deduction was to increase employee stock ownership at a bargain price (App., 19a); the ownership history

of the stock is irrelevant to the ESOP participants and the business enterprise that benefit from the ESOP stock ownership and from the bargain sale.[7]

(3) The executor's tax-induced sale was one with substantial economic substance and hardly a "sham transaction" as suggested by the Solicitor General's repeated quotation of then-Senator Bentsen's 1987 floor remarks (Petition, 5, 16, 17, 20).[8] The executor's sale at 5% below the mean trading price on December 12, 1986 (and significantly below the lowest price at which the MCI

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[7] The 1986 estate tax deduction was a part of the nation's long-standing policy of providing extraordinary encouragement for the growth of ESOPs through tax benefits. *See, e.g., 26 C.F.R. § 1.401-1(b)(1)(iii) (1956)* (subsequently amended). As summarized by the General Accounting Office late in 1986: "The major purposes of [ESOPs] are to broaden the ownership of stock, to provide a mechanism for financing capital growth and the transfer of stock ownership to employees, and to promote improvements in productivity and profitability in sponsoring firms. These goals are based on the belief that the concentration of stock ownership, the dependence of firms on internal sources of funds for corporate finance, and the slow growth of productivity in the U.S. are serious and related problems that can be addressed by making employees owners of stock in the firms that employ them." *Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership* (GAO/PEMD '87-'88 December 1986). *See generally* Staff of the Joint Committee on Taxation, 99th Cong., 1st Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* 1-15 (Comm. Print 1985) (summarizing the history of the promotion of ESOPs through the revenue laws).

[8] Traditionally, the term "sham transaction" describes a transaction without economic substance: one disguised in form in an attempt to obtain favorable tax treatment. *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960).

stock was traded that day) (App., 50a) accomplished a transfer of wealth from the beneficiaries of Mrs. Day's estate to the ESOP participants – as the majority recognized (App., 23a-24a). The ESOP was able to save about $400,000 compared with the mean trading price, and the executor sacrificed a similar amount. Like other ESOP-promoting provisions of the revenue laws, Section 2057 did not require any particular discount; rather, it left that to bargaining in the marketplace. For example, the law does not require any specific discount in a bank's interest charges in a stock acquisition loan for a bank to exclude from its taxable income one-half of the interest received from an ESOP. *See* 26 U.S.C. § 133 (Supp. III 1991). Similarly, the law does not require any specific discount in a stockholder's sales price to an ESOP to defer recognition of all gain realized on the sale. *See* 26 U.S.C. § 1042 (Supp. III 1991). In each case, however, a discount from market price is essential to the ESOP's participation and for the executor or bank or shareholder to be able to enjoy the benefit of the applicable deduction or exclusion (App., 23a).[9] Indeed, the government has conceded that the executor would not have sold the stock at a discount below market price and the ESOP trustee would not have been able to purchase it at a discount but for the Section

[9] The Solicitor General's observation that "[w]hether the estate made a profit or loss on the sale is irrelevant to the deduction under Section 2057" (Petition, 4, n.6) misses the point. Although gain or loss when compared with income tax basis is irrelevant, sale below market price is the *sine qua non* of the deduction; without a discount, an ESOP simply will buy stock in the open market and the executor will get no deduction. A sale above income tax basis but below fair market value is just as much a bargain sale as one below income tax basis.

2057 deduction (App., 51a). As the majority noted, "Section 2057 worked" (App., 19a).

(d) Finally, the Solicitor General implicitly contends that the executor had constructive notice that the restrictions would be imposed because of the factors *later* discussed during the legislative considerations of the 1987 amendments to the Section 2057 deduction (Petition, 5-6, 16-17, 20). By repeating the 1987 floor statements of then-Senator Bentsen and Representative Rostenkowski about the projections of revenue loss and the intent of the prior Congress when they introduced the 1987 amendment with its purportedly retroactive application,[10] the Solicitor General implies that the purportedly unintended revenue loss, which "became clear soon after the passage of the 1986 act" (Petition, 5), should have been anticipated by the executor when he sold his MCI stock at a discount in early December 1986 and should have forewarned him of the change. This position would require prescience on the part of the executor that the government itself lacked; it was not until January 5, 1987 that the Service released the advance version of Notice 87-13 and until February 26, 1987 that the chairmen of the Congressional tax-writing committees introduced the legislation to restrict the

[10] This Court should exercise its traditional skepticism about the weight that should be accorded the views of members of a later Congress about the intent of a former one. *See, e.g.*, *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 34 (1982) (citing *International Brotherhood of Teamsters v. United States*, 431 U.S. 324, 354, n.39 (1977)), particularly in view of the retirement of Senator Russell B. Long, who championed the cause of ESOPs as chairman (or ranking minority member) of the Senate Finance Committee from 1974 through the end of 1986.

availability of the Section 2057 deduction. The government has identified no basis for the premise that the executor could have known of a 1986 revenue-loss estimate or that he had the basis to make his own estimate. Moreover, as noted by the majority, even the revised revenue-loss estimate described by the legislators in February 1987 would have seemed plausible in the context of other spending for qualified plans (App., 20a-21a).

While review of fact-bound determinations such as the question of constructive notice in this case generally is not the purpose of certiorari, the foregoing demonstrates the substantial basis that undergirds the majority's decision. Thus, the legal question is the one set forth at the outset of this brief; it virtually answers itself. As demonstrated in the next section, the majority's analytic approach in applying traditional constitutional principles to the facts was consistent with established authority and not in conflict with the decisions of this Court or other decisions of the Court of Appeals.

II. THERE IS NO CONFLICT: THE NINTH CIRCUIT FOLLOWED TRADITIONAL DUE PROCESS ANALYSIS.

The majority identified and considered the traditional standards articulated by this Court in testing the retroactive application of the 1987 amendments to the Section 2057 deduction. It discussed both the "arbitrary and irrational"/"rational legislative purpose" formulation described in *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15 (1976), and *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 733 (1984), upon which the

Solicitor General primarily relies in his Petition and the "nature of the tax and the circumstances in which it is laid"/"harsh and oppressive" formulation identified in *United States v. Hemme*, 476 U.S. 558, 568-69 (1986), *United States v. Darusmont*, 449 U.S. 292, 299 (1981) (*per curiam*), and *Welch v. Henry*, 305 U.S. 134, 147 (1938) (App., 9a). Moreover, the majority recognized the consistency in result of those two formulations. App., 9a-10a (citing *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 733 (1984)).

The majority then reviewed the factual circumstances of several leading cases in which this Court has addressed a due process challenge to tax legislation (*Nichols v. Coolidge*, 274 U.S. 531 (1927); *Blodgett v. Holden*, 275 U.S. 142 (1927); *Untermyer v. Anderson*, 276 U.S. 440 (1928); *Welch v. Henry*, 305 U.S. 134 (1938); *United States v. Darusmont*, 449 U.S. 292 (1981) (*per curiam*); and, *United States v. Hemme*, 476 U.S. 558 (1986)) to determine the manner in which this Court has applied the formulations it has articulated – considering the "nature of the tax and the circumstances in which it is laid," as instructed by *Hemme* and *Welch* (App., 11a-17a). In addition, the majority reviewed two of the Ninth Circuit's own decisions (*Wheeler v. Commissioner*, 143 F.2d 162 (9th Cir. 1944), *rev'd on other grounds*, 324 U.S. 542 (1945), and *Licari v. Commissioner*, 946 F.2d 690 (9th Cir. 1991)) (App., 13a-14a, 16a-17a). As the dissent makes obvious, the Ninth Circuit panel also considered a substantial number of other decisions by this Court and various Circuits, although the

majority did not specifically discuss the facts and circumstances of each of them (App., 26a-33a).[11]

Having reviewed the tests prescribed by this Court and the ways in which they have been applied, the majority reviewed the unique facts and circumstances in which the present dispute arose, applied the tests to those unique facts, and concluded that the amendment to the estate tax deduction could not be applied consistently with the guarantee of the Due Process Clause (App., 17a-24a). In reaching that result, the majority emphasized several elements that distinguish the case at bar from the ones in which retroactive change was held to be permissible and that demonstrate the similarity to those in which retroactive change was not.

(a) Despite the two years of congressional consideration (App., 21a, 49a), there was no hint in the legislative history of Section 2057 as enacted in 1986 that Congress intended to restrict the deduction only to executors of persons who had owned stock during lifetime and only in circumstances in which the trustee of the ESOP allocated the stock to participants or held that stock for future allocation to participants in a particular fashion after the ESOP acquired it. Similarly, there was no hint that Congress or the Administration was contemplating such restrictions when the executor sold his stock to the ESOP and filed his estate tax return in this matter (App., 17a-18a).

(b) The executor was specifically induced to sell the MCI stock to its ESOP at below market value in order to share the estate tax benefits with the ESOP participants (App., 19a-20a).

(c) Particularly when considered in the context of other ways in which the tax law has been used to encourage the funding of ESOPs, the executor had no reason to suspect that the 1986 statute did not mean exactly what it said (App., 20a-21a).

(d) The executor suffered an actual loss, and not just a disappointed expectation, when he relied on the promise of an estate tax deduction in making the below-market sale to the ESOP (App., 19a, 21a-24a).

In summary, the majority engaged in the traditional due process analysis as articulated by this Court in *Hemme* and did not, as suggested by the Solicitor General in his Petition, adopt and apply "a novel and erroneous" one.

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[11] *Wiggins v. Commissioner*, 904 F.2d 311 (5th Cir. 1990); *Estate of Ekins v. Commissioner*, 797 F.2d 481 (7th Cir. 1986); *Fein v. United States*, 730 F.2d 1211 (8th Cir.), *cert. denied*, 469 U.S. 858 (1984); *Estate of Ceppi v. Commissioner*, 698 F.2d 17 (1st Cir.), *cert. denied*, 462 U.S. 1120 (1983); *Westwick v. Commissioner*, 636 F.2d 291 (10th Cir. 1980); *Purvis v. United States*, 501 F.2d 311 (9th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975); *First National Bank in Dallas v. United States*, 420 F.2d 725 (Ct. Cl.), *cert. denied*, 398 U.S. 950 (1970); *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960); *Miller v. Commissioner*, 115 F.2d 479 (9th Cir. 1940), *cert. denied*, 312 U.S. 703 (1941); *New England Baptist Hospital v. United States*, 807 F.2d 280 (1st Cir. 1986); *Canisius College v. United States*, 799 F.2d 18 (2d Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987); and, *Temple University v. United States*, 769 F.2d 126 (3d Cir. 1985), *cert. denied*, 476 U.S. 1182 (1986).

III. THE CASE WAS PROPERLY DECIDED: THE GOVERNMENT CANNOT RENEGE ON THE ESTATE TAX DEDUCTION AFTER IT HAS INDUCED THE EXECUTOR'S BELOW-MARKET SALE TO THE ESOP.

Retroactive application of the additional restrictions to the Section 2057 deduction to Mrs. Day's estate serves no legitimate legislative purpose and would produce a "harsh and oppressive" result in this circumstance. The Ninth Circuit decision is correct.

The Solicitor General suggests two purposes for application of the *post-hoc* requirements to this transaction:

> (a) "to fairly allocate to taxpayers the burdens and benefits of national fiscal policies" by providing a "uniform rule for all estates to which the tax deduction is available" (Petition, 14, 17); and
>
> (b) "to prevent evasion of [the revenue laws] 'by the vigilant and ingenious' " (Petition, 14, 16-17).[12]

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[12] Note that the Solicitor General does not argue as a matter of fact that retroactive application is necessary to protect the fisc, and there is no reason to believe that prospective application from the date of the Treasury's notice, the date of legislative introduction, or even the date of enactment would not produce roughly the same revenue result as retroactive application; similarly, the Solicitor General does not argue as a matter of law that raising revenue (by itself) provides a sufficient justification for retroactive application of laws depriving a citizen of the benefit of prior legislation that induced private conduct to pursue a public goal (whether that be funding an ESOP, building a canal or railroad, or buying and settling frontier land). Such a purported justification for the *post hoc* imposition of additional requirements would be no more compelling – or dispositive – today than it was in the 1920s and 1930s when this Court decided a series of estate and gift tax cases (*Nichols v. Coolidge*, 274 U.S. 531 (1927); *Blodgett v. Holden*, 275 U.S. 142 (1927); *Untermyer v. Anderson*, 276 U.S. 440 (1928); *Helvering v. Helmholz*, 296 U.S. 93 (1935); and, *White v. Poor*, 296 U.S. 98 (1935)) or over the prior Century when it decided a series of government-inducement cases. See discussion at pages 23-24, *infra*.

Neither withstands careful analysis, and each is premised on the Solicitor General's desired factual conclusion that the executor had constructive notice of the changes that the Solicitor General seeks to apply retroactively.

a. The Fair Allocation Purpose.

The Solicitor General's argument that application of the post-hoc restrictions to this case would produce a fair allocation ignores the facts of the case at bar. Neither Mrs. Day nor her executor enjoyed the economic benefit of prior conduct that gave rise to a particular cost, as was the case in *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976) (benefit payments for coal miners with black lung disease). Similarly, neither Mrs. Day nor her executor enjoyed the benefit of some current government program benefiting only a few, as was the case in *United States v. Sperry Corp.*, 493 U.S. 52 (1989) (user fee for those pursuing claims against the Government of Iran through the United States Claims Tribunal). Apparently recognizing the absence of any special relationship between either

Mrs. Day or her executor and the government, the Solicitor General simply argues that retroactive application of what he characterizes as "curative legislation" would provide a uniform rule for those executors who sold before January 5, 1987 and those who sold after January 4, 1987 (Petition, 14, 17).[13] That would hardly produce a "fair" allocation of the revenue needs of the United States.

Those executors who sold stock to an ESOP after the advance release of the Service's announcement on January 5, 1987 enjoyed constructive notice (if not actual notice) that the Administration might seek to limit the deduction to situations in which the stock was "directly owned" by the decedent and in which the ESOP would allocate the stock among participants in a particular fashion.[14] Those executors who had acquired stock after a decedent's death could avoid making a constructive gift

[13] The Solicitor General's repeated characterization of the limitations on the ESOP-proceeds deduction that he seeks to impose retroactively as "curative legislation" assumes the adoption of his view that the executor had constructive notice because there was an obvious mistake in or omission from the statutory language. If, as the majority concluded, the executor could not have had constructive notice, then the legislation is not "curing" a "defect" or "closing a loophole." (This is not a case of omitting a "not" in hastily-drafted legislative language, as might be inferred from the Solicitor General's arguments (Petition, 24).)

[14] The Solicitor General's assertion that the Service announced that "it was seeking curative legislation" in Notice 87-13 (Petition, 4) overstates the case; rather, the Service announced an administrative position "pending the enactment of *clarifying* legislation." Notice 87-13, 1987-1 C.B. 432, 442 (emphasis added).

to the ESOP participants by declining to make below-market sales; all executors selling to an ESOP could obtain a commitment from a purchasing ESOP to allocate the stock as the Service wished. Mrs. Day's executor, who had already made a below-market sale, had no similar warning or opportunity to avoid his loss. Rather than producing a "fair" allocation, retroactive application in this case produces one that is manifestly unfair to the beneficiaries of Mrs. Day's estate. As the majority put it,

> [t]he federal government has long sought to promote employee ownership of shares in their employers. Section 2057 was enacted to induce taxpayers to sell shares at a discounted price to an ESOP, thus furthering the public policy of employee ownership. As intended, the Day estate succumbed to the lure and sold shares to the MCI ESOP at a substantial discount. Section 2057 worked. An ESOP was able to buy more shares at a lower price than before. Then, when the private actor had completed the socially desirable action of selling shares at a discount to an ESOP, the government reneged on its end of the deal. It was too late for Carlton to undo his sale to the MCI ESOP. The $631,000 was gone forever, irretrievable.

(App., 19a.) Like Mrs. Coolidge (in *Nichols v. Coolidge*, 274 U.S. 531 (1927)) and Mr. Blodgett (in *Blodgett v. Holden*, 275 U.S. 142 (1927)), who had no opportunity to rescind their *inter vivos* gifts that had preceded the estate and gift taxes, respectively, Mrs. Day's executor had no way to turn back the clock and choose a different course of

conduct after the Service's advance release of its notice.[15] If a "wholly new tax" cannot be imposed retroactively because doing so would be "harsh and oppressive," then *a fortiorari*, the government cannot allow a deduction if the tax benefit is shared with the ESOP and then renege after Mrs. Day's executor made the below-market sale and filed the estate tax return.[16]

Retroactive application would be arbitrary and irrational and would not serve any rational legislative purpose, because it will create an uncertainty that will discourage the people from accepting any new or unproven inducement to assist in the accomplishment of

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[15] The facts of the instant case are substantially more compelling than those of *Coolidge* and *Blodgett*. There, gifts were made in the absence of a transfer tax; here the below-market sale was specifically induced by the ESOP-proceeds deduction.

[16] In his discussion of the *Coolidge* and *Blodgett* cases, the Solicitor General cites with approval an article by Professor Hochman (Petition, n. 11). He defines the appropriate test for retroactive tax legislation in his article as follows: "The primary consideration which appears from an analysis of the cases involving retroactive taxation is the ability of the taxpayer, at the time of the transaction dispute, reasonably to have foreseen that a tax would be imposed, and the likelihood that, having been able to foresee it, he would have altered his conduct to avoid the tax." Charles B. Hochman, *The Supreme Court and The Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692, 706 (1960) (footnote omitted). Here, the government has stipulated that the executor would *not* have made the bargain sale to the ESOP (and the ESOP participants would *not* have been enriched by the benefit of that bargain) but for the executor's expectation of a deduction under Section 2057 (App., 19a, 51a).

governmental objectives.[17] It is important to the implementation of governmental policy generally, as well as "a simple constitutional principle," that when it induces reliance, *"government must keep its word."* Laurence H. Tribe, *American Constitutional Law*, 619 (2d ed. 1988) (discussing limitations on state government action) (footnote omitted).[18]

The impermissibility of reneging on a promised benefit after inducing private conduct to pursue public goals has been a fundamental premise of this Court's jurisprudence since the earliest days of the Republic. Sometimes explained as a matter of "universal law," sometimes founded in the Contract Clause, and more recently based primarily on the Due Process Clauses of the Fifth and Fourteenth Amendments, this notion long predates the estate and gift tax cases of the earlier part of this century and is much broader than simply a prohibition against retroactive imposition of a "wholly new tax." *See Fletcher v. Peck*, 10 U.S. (6 Cranch) 87 (1810) (purchase of land-grant property); *New Jersey v. Wilson*, 11 U.S. (7 Cranch) 164 (1812) (property tax exemption for formerly Indian-owned lands); *Trustees of Dartmouth College v. Woodward*,

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[17] How long should a prudent banker wait for possible legislative change before making a share acquisition loan to an ESOP at a below-market interest rate and thereby sharing with the ESOP participants and corporate sponsor the promised benefit of the bank's ability to exclude one-half of the interest from taxable income under 26 U.S.C. § 133?

[18] As discussed at pages 10-11 above and in the authorities cited in note 7, the government long has used the revenue laws to promote employee stock ownership generally and ESOPs in particular.

17 U.S. (4 Wheat.) 518 (1819) (*de facto* change to college charter); *The Binghamton Bridge*, 70 U.S. (3 Wall.) 51 (1866) (exclusive franchise); *Wilmington Railroad v. Reid*, 80 U.S. (13 Wall.) 264 (1871) (franchise tax exemption); *Humphrey v. Pegues*, 83 U.S. (16 Wall.) 244 (1872) (property tax exemption); *Pacific Railroad Co. v. Maguire*, 87 U.S. (20 Wall.) 36 (1873) (tax exemption); *Forbes Pioneer Boat Line v. Board of Commissioners*, 258 U.S. 338 (1922) (collection of canal tolls). Although the rationale – particularly with respect to the conduct of state governments – has evolved over time,[19] the underlying principle has remained constant.

The Solicitor General's fair allocation position in this case is a somewhat ironic one in light of the effective-date provisions of many of the other 1987 amendments to the ESOP-proceeds deduction. In addition to the decedent-ownership and allocation requirements involved in this case, the 1987 legislation imposed a number of additional constraints that dramatically narrowed the scope of the deduction for ESOP sales made after February 26, 1987 (the date of introduction of the legislation). *Omnibus Budget Reconciliation Act of 1987*, Pub. L. No. 100-203, § 10412, 101 Stat. 1330-433 to 1330-436. These included (1) a limit on the maximum deduction (the lesser of that deduction that would result in a $750,000 tax savings or a deduction equal to one-half of the taxable estate without the deduction), (2) a reduction of the sales proceeds that could

[19] *Cf.* Alexander M. Bickel & Benno C. Schmidt, Jr., *The Judiciary and Responsible Government 1910-21*, 300 (The Oliver Wendall Holmes Devise History of the Supreme Court of the United States Vol. IX, 1984).

qualify in the event the ESOP had purchased or sold employer securities in the prior year, (3) a disqualification of proceeds attributable to assets transferred to an ESOP from other forms of tax-exempt retirement plans (unless the Service determined otherwise), (4) a requirement that proceeds be received before the estate tax return was due, (5) a disqualification of stock a decedent acquired as compensation (whether tax-deferred or not) from the employer, (6) a limit to securities of an issuer that does not have any stock that is readily tradable on an established securities market, (7) a holding period requirement dating back to October 22, 1986 for the decedent or his or her spouse, and (8) a provision that disqualified stock if the decedent had engaged in some kinds of hedging transactions to reduce the risk of loss if the stock declined in value (App., 53a; *Omnibus Budget Reconciliation Act of 1987*, Pub. L. No. 100-203, § 10412; 101 Stat. 1330-433 to 1330-436). Executors who sold before the introduction of the legislation but who did not meet one or more of *these* restrictions still were eligible for the deduction. The only distinction between the two restrictions contained in the 1987 legislation that were supposed to be applied retroactively and the eight to be applied prospectively is that the two were presaged by the Service's administrative ruling position set forth in the January notice. Here, the executor acted several weeks *before* the Service's advance release of the notice on January 5, yet the government seeks to apply them to his situation. Doing so would treat similarly situated taxpayers (ones who acted before any hint of change) differently: the same notion of due process that supports a date-of-introduction distinction for the eight other restrictions enacted

by the 1987 legislation supports the result urged by the executor and reached by the Ninth Circuit in this case.

In summary, the Solicitor General's "fair allocation" purpose for retroactive application of the *post hoc* conditions to this transaction does not withstand scrutiny: there is no unusual government benefit now enjoyed by Mrs. Day's executor; neither she nor her executor has enjoyed any particular economic benefit as a result of prior conduct that has given rise to a particular cost borne by the government; and, to impose a constructive gift on Mrs. Day's beneficiaries by retroactive application would be manifestly unfair and would violate traditional constitutional principles embodied in the gift and estate tax cases decided under the Due Process Clause and as a consistent theme through our constitutional jurisprudence in other areas. Indeed, application to the case at bar where the executor acted several weeks before the Service's advance release of Notice 87-13 would be inconsistent with the general notion of due process inherent in the effective date provisions for the other 1987 changes affecting Section 2057. In short, retroactive application could lead to a "fair allocation" only if the executor had constructive notice.

b. The Tax Evasion Purpose

The Solicitor General's suggestion that the transaction at bar was an attempt by "the ingenious" to "evade" part of the burden of the estate tax also assumes the factual result that the Solicitor General pursues in this matter. As observed by the majority, "[i]t is undisputed that Carlton had no actual knowledge of the 1987 amendment imposing the decedent ownership requirement when he completed the MCI ESOP transaction" (App., 17a). The majority was correct that the executor did not have constructive notice of the change (first proposed by the Treasury on January 5) when the executor made his below-market sale on the prior December 12 (App., 17a-18a, 33a-35a) for the reasons set forth at pages 6 through 14 above. Absent constructive notice, the executor cannot have been engaged in "evasion," and this hypothesized purpose for retroactive application of the additional restrictions to the ESOP-proceeds deduction lacks a rational basis. The executor simply was doing what the new law encouraged him to do – share an expected tax savings with the ESOP.

IV. THE RESULT DOES NOT HAMSTRING THE GOVERNMENT.

The Ninth Circuit decision is narrowly written, emphasizing the unique factual circumstances in which this case arises, and imposes no impediment to the routine and necessary revision of the revenue laws of the United States.

As disclosed by the Solicitor General (Petition, n. 3), the Section 2057 deduction has been repealed in its entirety (Petition, n. 8; Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7304(a), 103 Stat. 2352-2353). The Ninth Circuit decision clearly relates only to this one transaction and to any other transaction that may have occurred between the President's signature of the 1986 legislation on October 22, 1986 and the Service's

advance release of its Notice 87-13 on January 5, 1987 (App., 24a) – a period of less than 2-1/2 months. Indeed, the majority suggests that it likely would reach a contrary result for any transaction that occurred after January 5, 1987 (App., 24a), and the Fifth Circuit recently has so concluded in the *Ferman* case (App., 56a).

The majority stresses the essential difference between the situation at bar and those in which this Court and the Ninth and other Circuits have rejected due-process challenges to retroactively-applied revenue laws in the past: the government encouraged Mrs. Day's executor to make a below-market sale to the ESOP with the estate tax deduction (App., 19a, 24a). Having induced this private conduct to pursue a public goal, the government now is constrained from applying the *post hoc* amendments to deprive the executor of the tax benefit. The cases cited by the Solicitor General to support retroactive application are clearly distinguishable, because none involves a situation like the case at bar (and, indeed, most involve situations in which the President had proposed or the Congress was actively considering legislative change at the time a taxpayer acted).

CONCLUSION

For the reasons set forth above, the Court should deny the petition for writ of certiorari.

Respectfully submitted,

Russell G. Allen
Counsel for Respondent

July 1993

APPENDIX E

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

SA CV 90-685 AHS (RWRx)

JERRY W. CARLTON, ETC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

STIPULATION AND ORDER
OF UNCONTROVERTED FACTS
AND NARROWING POTENTIAL ISSUES
IN CONTROVERSY

[Filed Mar. 27, 1991]

UNCONTROVERTED FACTS

1. Plaintiff, Jerry W. Carlton, is the executor of the will of Willametta K. Day ("Mrs. Day" and the "Estate," respectively) and an individual residing in Orange County, California.

2. Mrs. Day was a citizen of the United States of America who died on September 29, 1985; taking into consideration an extension of time to file, her estate tax return was due December 29, 1986.

3. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (the "TRA"), was enacted on October 22, 1986. The TRA added new Section 2057 to the Internal Revenue Code ("Code"), which permitted fifty percent of

the qualified proceeds of a qualified sale of any employer securities to an Employee Stock Ownership Plan ("ESOP") to be deducted from the value of a decedent's gross estate. TRA § 1172(a), at 2513-14. * * * * The new deduction was made applicable to sales by executors required to file a return (including extensions) after enactment (and not just to persons dying after enactment). TRA § 1172(c), at 2515.

4. Between passage of the TRA by the Congress (as H.R. 3838) and Congress' adjournment several weeks later, a large number of potential technical and clerical corrections were identified and considered by the Congress as House Concurrent Resolution 395. As summarized in the "Blue Book" prepared by the Joint Committee on Taxation in the spring of 1987:

> On September 25, 1986, immediately after its approval of the conference report on H.R. 3838, the House passed (by voice vote) H. Con. Res. 395, to instruct the enrolling clerk to make certain technical and clerical corrections in the conference report statute.
>
> H. Con. Res. 395 was agreed to by the Senate (by voice vote) on October 16, 1986, with amendments. The House Rules Committee granted a rule on October 16, and the House adopted the rule (by voice vote) on October 17 for consideration of the resolution as amended by the Senate. Also on October 17, the House concurred in the Senate amendment with further amendments and returned the resolution to the Senate.
>
> On October 18, 1986, the Senate agreed (by voice vote) to certain of the House amendments to the resolution, disagreed to certain other amendments, and insisted on certain of its amendments. Also on October 18, the House disagreed to the Senate amendments to the House amendments to the original Senate amendment. H. Con. Res. 395 was not agreed to by both the House and the Senate before the 99th Congress adjourned *sine die* on October 18, 1986.

Joint Comm. on Tax., 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 4 (1987). During this consideration of several hundred potential technical and clerical amendments to the TRA, the Congress considered only one change to the new Section 2057 deduction – deletion of an extraneous "is" in Section 2057(b)(1). H.R. Con. Res. 395, 99th Cong., 2d Sess., 132 Cong. Rec. [32345, 32348, col. 1, reference to p. 453] (1986) [S16391, S16393 (daily ed. October 16, 1986)]. * * * *

5. Similarly, the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (1986) – which was passed by the Congress after the TRA but signed by the President before the TRA – contained several changes to the TRA; none affected Section 2057.

6. No bill or resolution was introduced that would have added any condition to the availability of the new Section 2057 deduction other than those contained in the statute itself during the period between passage of the TRA and adjournment on October 18, 1986.

7. A legislative precursor of Section 2057 as enacted by the TRA was contained in the Senate version of the Deficit Reduction Act of 1984 (98th Cong., H.R. 4170). * * * *

8. In discharge of his duty as executor, plaintiff reviewed the provisions of the TRA and the amendments and possible amendments to it proposed before Congress adjourned and determined that it was in the Estate's financial interest to avail itself of the new Section 2057 deduction.

9. In an effort to reduce the estate tax payable as a result of Mrs. Day's death and to facilitate an ESOP's purchase of employer securities at a discounted price and in reliance on new Section 2057, plaintiff purchased 1,500,000 shares of MCI stock on December 10, 1986 for an average price of about $7.47 per share, or a total purchase price of $11,206,000, from Goldman, Sachs & Co., a broker who routinely makes a market in the over-the-counter stock. * * * *

10. Although plaintiff had determined that the trustee of MCI's ESOP might be interested in acquiring some MCI stock, plaintiff had no advance agreement to sell the stock to the trustee when plaintiff bought it and, thus, bore the risk of loss if the market for the stock declined or if plaintiff had to sell it back to a market maker for less than the purchase price.

11. On December 12, 1986, two days after purchasing the stock, plaintiff entered into an agreement to sell MCI stock to the trustee of MCI's ESOP for $7.05 per share, or a total sale price of $10,575,000. The National Association of Security Dealers, which reports daily on trading of MCI stock, reported that the price ranged from $7.125 to $7.50 per share on that day. * * * *

12. In accordance with Section 2057 as originally enacted, plaintiff obtained MCI's agreement to the application of 26 U.S.C. Section 4979A to it. * * * * Plaintiff also obtained an opinion from MCI's general counsel that its ESOP was a plan as identified in 26 U.S.C. Section 4975(e)(7).

13. On December 17, 1986, the sale was consummated.

14. Plaintiff would not have purchased the stock at its then-prevailing price of about $7.47 per share and sold the stock to the ESOP at a discounted $7.05 per share price (and incurred incidental transaction costs) if the executor had not anticipated a Section 2057 deduction. Similarly, the ESOP would not have been able to purchase the stock at the discounted price if the executor had not expected the Section 2057 deduction.

15. On December 29, 1986, plaintiff timely filed the United States Estate Tax Return, Form 706 (the "Return"), for the Estate. Pursuant to Section 2057 as it existed at that time, plaintiff deducted $5,287,500, fifty percent of the proceeds received from the ESOP on the sale of the MCI stock, from the value of Mrs. Day's gross estate. Overall, plaintiff reported and paid a net estate tax of $18,752,250.

16. On January 5, 1987 and on January 26, 1987, respectively, the Service issued an advance version of and then formally published Notice 87-13 (the "Notice") addressing a number of miscellaneous statutory changes affecting employee plans. I.R.S. Notice 87-13, 1987-1 C.B. 432. Question and Answer 23 of the Notice indicated that "[p]ending the enactment of clarifying legislation," the

Service would *not* recognize the deduction permitted under Section 2057 (1) unless a decedent "directly owned" the securities before death and (2) unless the securities were allocated or held for future allocation by the plan in particular ways. *Id.* at 442. * * * *

17. Neither of the requirements announced in the Notice was contained in the statute as originally enacted, neither was identified in the proposed technical and clerical amendments discussed before Congress adjourned, and neither was added to the statute (although other changes to the TRA were made) before Congress adjourned.

18. On February 26, 1987, what became Section 10411 of the Omnibus Budget Reconciliation Act of 1987 ("OBRA") was introduced in Congress. Section 10411 of OBRA proposed to amend Section 2057 to impose the additional requirements identified in the Notice – effective retroactively. * * * *

* * * *

20. On December 22, 1987, Section 10411 of OBRA was enacted, amending Section 2057 to require that a decedent "directly own" securities immediately before death and that the ESOP comply with the Notice's additional allocation rules in order for a selling estate to qualify for the deduction. Pub. L. No. 100-203, § 10411(a), 101 Stat. 1330-432 (1987). The heading of OBRA § 10411 is titled "CONGRESSIONAL CLARIFICATION OF ESTATE TAX DEDUCTION FOR SALES OF EMPLOYER SECURITIES." Paragraph (a) of the section is titled "INTENT OF CONGRESS IN ENACTING SECTION 2057 OF THE INTERNAL REVENUE CODE OF 1986." * * * *

21. In addition to the purportedly retroactive changes to Section 2057, OBRA added a number of other constraints to Section 2057 to be applied only to sales made after February 26, 1987 (the date of introduction). These included a limit on the maximum deduction (the lesser of that deduction that will result in a $750,000 tax savings or a deduction equal to one-half of the taxable estate without the deduction), a reduction of the sales proceeds that could qualify in the event the ESOP had purchased or sold employer securities in the prior year, a disqualification of proceeds attributable to assets transferred to an ESOP from other forms of tax-exempt retirement plans unless the Service determined otherwise, a requirement that proceeds be received before the estate tax return is due, a disqualification of stock a decedent acquired as compensation (whether tax-deferred or not) from the employer, a limit to stock that is not readily tradable on an established securities market, a holding period requirement dating back to October 22, 1986 for the decedent or his spouse, and a provision that disqualified stock if the decedent had engaged in some kinds of hedging transactions to reduce the risk of loss if the stock declined in value.

22. Section 2057 was repealed * * * * by Section 7304(a) of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7304(a), 103 Stat. 2106, 2352-54 (1989).

23. The federal estate tax return for Mrs. Day's estate was subsequently audited, and the Internal Revenue Service issued a Report of Estate Tax Examination changes to the Executor on March 13, 1989 with adjustments which resulted in an estate tax deficiency of

$3,385,333.00. The net deficiency attributable to the § 2057 adjustment was $2,501,161.00. Plaintiff does not dispute the other adjustments.

24. On March 30, 1989, plaintiff paid the total deficiency of $3,385,333.00, plus $996,953.18 interest. On July 3, 1989, plaintiff filed a claim for refund of $2,501,161.00 * * * * , which was denied on August 1, 1989. * * * * The Executor subsequently filed the complaint upon which this case is based, on October 11, 1990, seeking a refund of $2,501,161.00, plus interest and costs, including attorneys' fees.

NARROWING POTENTIAL ISSUES IN CONTROVERSY

25. If the provisions of Pub. L. No. 100-203, § 10411(a), 101 Stat. 1330-432 (1987) amending Section 2057 of the Internal Revenue Code of 1986 cannot constitutionally be applied to eliminate the deduction claimed pursuant to that section on Mrs. Day's federal estate tax return as it was filed, then the taxpayer is entitled to judgment as sought in the complaint. (The United States does not contest the taxpayer's entitlement to the deduction as the statute existed when the estate tax return was filed or oppose the refund on any basis other than the 1987 amendment to Section 2057.)

26. If, on the other hand, that amendment can be applied to eliminate the deduction claimed by the executor, then the Government is entitled to judgment in these proceedings. (The taxpayer does not assert any basis for a

refund other than that the amendment to Section 2057 cannot constitutionally be applied in this situation.)

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ORDER

IT IS SO ORDERED.

Dated: March 27, 1991

/s/ Alicemarie H. Stotler
ALICEMARIE H. STOTLER
United States District Judge

APPENDIX F

Bertha Paglin FERMAN, etc.,
Plaintiff-Appellant,

v.

UNITED STATES of America,
Defendant-Appellee.

No. 92-3482.

United States Court of Appeals,
Fifth Circuit.

June 18, 1993.

Taxpayer brought suit to obtain refund of federal estate taxes. The United States District Court for the Eastern District of Louisiana, George Arceneaux, Jr., J., 790 F.Supp. 656, granted summary judgment in favor of government, and taxpayer appealed. The Court of Appeals, King, Circuit Judge, held that amendment to Internal Revenue Code, which retroactively restricted availability of state tax deduction for sale of employer securities to employee stock ownership plan, did not violate due process.

Affirmed.

Appeals from the United States District Court for the Eastern District of Louisiana.

Before KING and EMILIO M. GARZA, Circuit Judges, and HALL,* District Judge.

KING, Circuit Judge:

Bertha Paglin Ferman, acting in her capacity as executrix of the estate of Jules J. Paglin, brought this action against the United States to obtain a refund of $117,362.03 in federal estate taxes, plus interest and costs. Ferman asserts that an amendment to the Internal Revenue Code, which retroactively restricted the availability of an estate tax deduction for the sale of employer securities to an employee stock ownership plan, violates due process as applied to Paglin's estate. The parties filed cross-motions for summary judgment before the district court, which granted summary judgment in favor of the government. Ferman appeals from that judgment. Finding that, in the context of the facts before us, the retroactive amendment to the deduction at issue does not constitute a violation of due process, we affirm the district court's grant of summary judgment in favor of the government.

I. BACKGROUND

The facts in the case before us are not in dispute, and they have been presented by the court below. *See Ferman v. United States,* 790 F.Supp. 656 (E.D.La.1992). Following is a brief discussion of (a) section 2057 of Title 26 and its amendment, (b) the facts relevant to this appeal, and (c) the proceedings below.

A. *Section 2057*

The Tax Reform Act of 1986, Pub.L. No. 99-514, 100 Stat. 2085 (the Act), was enacted on October 22, 1986. Section 1172(a) of the Act added section 2057 to the

Internal Revenue Code, which allowed estates a deduction for fifty percent of the "qualified proceeds" of a "qualified sale" of any employer securities to an employee stock ownership plan (ESOP). *See* 26 U.S.C. § 2057. The term "qualified sale" was defined as "any sale of employer securities by the executor of an estate to . . . an employee stock ownership plan . . . described in section 4975(e)(7)." 26 U.S.C. § 2057(b)(1). "Qualified proceeds" was defined as "the amount received by the estate from the sale of employer securities at any time before the date on which the return of the tax imposed by section 2001 is required to be filed." 26 U.S.C. § 2057(c)(1). Under section 1172(c) of the Act, section 2057 was made applicable to sales by executors required to file estate tax returns after the date of its enactment. As discussed below, section 2057 made it possible for the executor of an estate to purchase stock from a company and then resell that stock to the company's ESOP – usually at a discount so as to provide an incentive for the ESOP to participate in the transaction – in order to receive a fifty percent deduction on the proceeds of that sale.

On January 5, 1987, the Internal Revenue Service (IRS) issued a news release addressing a number of statutory changes affecting employee plans. This notice was formally published on January 25, 1987 as Notice 87-13, 1987-1 C.B. 432 (Notice 87-13). "Question-and-answer 23" of Notice 87-13 indicated that, "[p]ending the enactment of clarifying legislation," the IRS would not recognize the deduction permitted under section 2057 unless (1) the decedent directly owned securities *before death* and (2) the

securities were allocated or held for future allocation by the plan in specified ways. *Id.* at 442.

On February 26, 1987, proposed legislation concerning the scope of section 2057's deduction was introduced into Congress. The bill's sponsors stated that it "would confirm the positions taken in IRS Notice 87-13" and that, "[b]ecause these provisions accurately reflect Congressional intent in enacting the provision, this clarification would be effective as if included in the [1986 Act]." 133 Cong. Rec. H845 (daily ed. Feb. 27, 1987); 133 Cong.Rec. S2532 (daily ed. Feb. 27, 1987). This proposal made its way into the Omnibus Reconciliation Act of 1987, Pub.L. No. 100-185, 101 Stat. 1330 (the 1987 Act), which was enacted into law on December 22, 1987. Section 10411 of this Act amended section 2057 of the Internal Revenue Code to impose the additional requirements identified in Notice 87-13, effective as if the provision had been contained in the 1986 Act.[1] The legislative history behind the enactment of the 1987 Act states, in pertinent part,

> [i]n enacting the estate tax deduction[,] Congress intended that it would be utilized in a limited number of transactions with a relatively modest revenue loss. As drafted, the estate tax deduction was significantly broader than what was originally contemplated by Congress in enacting the provision. The committee believes it is necessary to conform the statute to the

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[1] Although not important for the purposes of resolving the case before us, we note that section 2057 was subsequently repealed for the estates of persons dying after July 12, 1989. *See* Omnibus Budget Reconciliation Act of 1989. Pub.L. No. 101-239, 103 Stat. 2106, 2352-2354, § 7304(a).

original intent of Congress in order to prevent a significant revenue loss under the Tax Reform Act of 1986.

While Congress intended to encourage transfers of employer securities to ESOPs by providing for partial elimination of estate tax liability, it was not intended that estates be able to eliminate all estate tax liability through use of the deduction[,] or that the securities acquired in a transaction for which the deduction was claimed need not be allocated to plan participants. The provision would not have been adopted in its present form had the full extent of the revenue impact and the effect of the provision been recognized.

The committee concludes that it is now necessary to modify the provision to bring the revenue loss in line with the original estimate and congressional intent. The modifications contained in the bill are designed to achieve this result while maintaining to the fullest extent possible the incentive to transfer employer securities to ESOPs.

The primary thrust of the bill is to conform the provision to the original intent of Congress in enacting the deduction. In this respect, the bill has two elements.

First, the bill makes clear that the positions taken by the Internal Revenue Service in Notice 87-13 with respect to the estate tax deduction are an accurate statement of Congressional intent in enacting the provision. If these clarifications are not made, taxpayers could qualify for the deduction by engaging in essentially sham transactions.

Second, the bill makes additional changes in the deduction which more fully effectuate the intent of Congress to provide limited relief for the estate tax.

H.R.Rep. No. 100-391(II), 100th Cong., 1st Sess. 1045 (1987), *codified at* 4 U.S.C.C.A.N. 2313-1, 2313-661 (1987); *see also* H.R.Conf. Rep. No. 100-495, 100th Cong., 1st Sess. at 998 (1987), *codified at* 4 U.S.C.C.A.N. 2313-1245, 2313-1744 (1987) (adopting the House version of the bill).

B. *The Paglin Estate's Reliance on the Unamended Version of Section 2057*

Bertha Paglin Ferman is the testamentary executrix of the estate of her father, Jules J. Paglin (decedent). At the time of his death on October 27, 1986, the decedent owned stock in over 75 publicly traded corporations, including 100 shares of ALZA Corporation stock valued at $2,031.25; the decedent had no legal relationship with the ALZA ESOP at the time of his death.

From February 20 to February 24, 1987, decedent's estate entered into three series of transactions in which it purchased shares of ALZA Corporation stock, and then sold those shares to the ALZA Corporation ESOP: (1) on February 20, the estate purchased 12,300 shares of stock at a total cost of $348,960, which it sold to the ESOP that same day for $329,175; (2) on February 23, the estate purchased 112,200 [sic] shares of ALZA stock for $329,090, which it sold to the ESOP that same day for $310,317.50; and (3) on February 24, the estate purchased 11,200 shares of ALZA Corporation common stock for

$310,100, which it sold to the ESOP that day for $292,600.[2] The parties have stipulated that the $7,000 brokerage commission paid by the estate when originally purchasing the stock and the stock value discounts given to the ESOP resulted in a total loss to the estate of $49,057.50.[3]

Ferman entered these transactions on the advice of her attorneys in order to realize a tax deduction under section 2057, and the parties have stipulated that her "decision to purchase these shares of ALZA stock, pay the commissions due on the purchases, and resell the stock to the ALZA ESOP at a discount, was purely tax motivated." The parties have also stipulated that

> [t]he only reason that the estate purchased ALZA stock, as opposed to the stock of another company, was the fact that the ALZA ESOP had by prior agreement agreed to purchase at a discount the entire quantity of ALZA Corporation stock directly from the estate, and the ALZA ESOP agreed to make the purchase from the estate over the three-day period.

Ferman also chose the ALZA ESOP because it agreed to purchase the shares at a lower discount than the other ESOPs she contacted.

On December 15, 1987, the estate filed a claim with the IRS for a refund on its federal estate taxes in the amount of $177,362.03, plus interest. According to the

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[2] These stock purchase prices include brokerage commissions paid by the estate and, therefore, they do not reflect the actual market value of the stock.

[3] The record does not disclose whether the estate in any way claimed this loss as a tax deduction.

estate, it was entitled to a deduction under section 2057 in the amount of $466,046.25, or one-half of the $932,092.50 total proceeds received from its sales of ALZA Corporation stock to the ALZA ESOP. This deduction reduced the decedent's taxable estate from $1,869,839.03 to $1,403,792.78, and the estate's tax liability from $511,097.55 to $333,735.52, for a total savings of $177,362.03. The IRS denied the estate's refund claim on January 31, 1990.

C. *Proceedings*

Soon after the IRS denied the estate's refund, Ferman instituted this action contending that (1) the estate is entitled to the ESOP sales deduction because it fully complied with the plain meaning of section 2057 as it existed at the time the sales were consummated, and (2) retroactive application of the 1987 Act to the estate's circumstances violates the Due Process Clause of the Fifth Amendment. Ferman moved for summary judgment, and the IRS filed a cross-motion for summary judgment, contending that the government's retroactive amendment to section 2057 does not constitute a violation of due process.

The district court granted summary judgment in favor of the IRS, holding that the government's retroactive amendment to section 2057 does not violate the Due Process Clause. First, the court rejected Ferman's argument that "she could not have foreseen Congress' retroactive amendment of section 2057 because no legislative action took place until after she completed the stock transfers at issue." *Ferman*, 790 F.Supp. at 661. According

to the district court, "Notice 87-13 forewarned what the future could and ultimately did bring." *Id.* The court also stated that "[i]t would seem abundantly clear that, given the IRS' position, Congress would enact corrective and retroactive legislation at the earliest possible time." *Id.* The district court also noted that, "[w]hile the net effect of the 1987 amendments to section 2057 clearly denied the Paglin estate the benefits of the fifty percent deduction, such denial did not amount to a 'new tax' as contemplated by the relevant law." *Id.*

Finally, the district court dismissed the estate's reliance upon such cases as *Untermyer v. Anderson*, 276 U.S. 440, 48 S.Ct. 353, 72 L.Ed. 645 (1928), and *Blodgett v. Holden*, 275 U.S. 142, 48 S.Ct. 105, 72 L.Ed. 206, *modified*, 276 U.S. 594, 48 S.Ct. 105, 72 L.Ed. 206 (1928), where the Supreme Court refused to subject gifts to the gift tax where they were completed before the first gift tax had even been implemented. The district court recognized that, in *United States v. Hemme*, 476 U.S. 558, 106 S.Ct. 2071, 90 L.Ed.2d 538 (1986), the Supreme Court limited *Untermyer* to its facts, specifically stating that *Untermyer* is of questionable value in assessing the constitutionality of amendments that bring about changes in the operation of *existing* tax laws. Accordingly, the district court distinguished *Untermyer* and *Blodgett* from the case before us on the grounds that this case "does not involve a new estate tax on intervivos gifts but, rather, a change in the application of an estate tax deduction." *Id.* at 662. In sum, although the district court stated that, "[i]n all candor, the court, in this instance, sincerely hopes that, should its judgment be appealed, the court (or courts) above will find error in this ruling[,]" it concluded that "it is true

beyond peradventure that Congress may surely correct any error or inadvertence it may have created; indeed, Congress is constitutionally able to change and modify our nation's tax laws at will." *Id.* at 662-63.

II. ANALYSIS

The parties have stipulated that (1) the government erred in drafting section 2057 in that it failed to properly estimate the cost to the United States Treasury resulting from the deduction created under this section, (2) the government's statutory power to tax generally includes the discretion to correct such mistakes, and, (3) solely as a result of this deduction, Ferman entered into transactions which, although they benefited the estate under the unamended version of section 2057, were otherwise to the detriment of the estate in the amount of $49,057.50.[4] On appeal, Ferman contends that she reasonably relied upon section 2057 when entering into the transactions at issue between February 20 and February 24, 1987. The government contends that (1) it acted within its taxing authority in applying its 1987 amendment to section 2057 retroactively, for this amendment constitutes an adjustment to an existing tax rather than a new tax, and (2) Ferman's reliance on section 2057 was not reasonable in light of (a) Notice 87-113, (b) the legislative history behind section 2057, and (c) the extent of the government's error in drafting section 2057. Accordingly, the issue before us

[4] This amount constitutes the aggregate of (1) the broker's commissions paid by the estate when it purchased the ALZA stock and (2) the discounts given to the ALZA ESOP on the price of the stock.

constitutes a question of law: We must determine whether, in the context of the facts before us, the government's retroactive application of its amendment to section 2057 constitutes a violation of due process or a legitimate exercise of the government's statutory power to tax.

The Supreme Court has held that the retroactive application of a tax statute violates the Due Process Clause where the result is "so harsh and oppressive as to transgress the constitutional limitation." *Hemme,* 476 U.S. at 568-69, 106 S.Ct. at 2078, *quoting Welch v. Henry,* 305 U.S. 134, 147, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938).[5] In making such a determination, courts must "consider the nature of the tax and the circumstances in which it is laid. . . . " *Hemme,* 476 U.S. at 568-69, 106 S.Ct. at 2078.

In *Welch,* the case in which the Court introduced this "harsh and oppressive" impact standard, a Wisconsin taxpayer challenged the state's imposition of additional taxes arising from a change in the tax rate on corporate dividends received by the taxpayer one and two years

[5] Outside of the tax context, the Court has held that the retroactive application of a statute must be "arbitrary and irrational" to violate due process. *See Usery v. Turner Elkhorn Mining Co.,* 428 U.S. 1, 15, 96 S.Ct. 2882, 2892, 49 L.Ed.2d 752 (1976). Nevertheless, this difference is actually just one of semantics, for the Court has held that the "harsh and oppressive" impact standard used in the tax context "does not differ from the prohibition against arbitrary and irrational legislation that we clearly enunciated in *Turner Elkhorn." Pension Benefit Guaranty Corp. v. R.A. Gray & Co.,* 467 U.S. 717, 733, 104 S.Ct. 2709, 2720, 81 L.Ed.2d 601 (1984).

earlier. Although it had previously struck down retroactive taxes on gifts,[6] the Court upheld the Wisconsin statute by distinguishing the tax at issue from gift taxes. Specifically, the Court held that

> a tax on the receipt of income is not comparable to a gift tax. We cannot assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one. . . .

305 U.S. at 148, 59 S.Ct. at 126. The Court then went on to place the right to tax income retroactively within the realm of the broad taxing power of legislatures, stating that

> [w]e cannot say that the due process which the Constitution exacts denies that opportunity to legislatures; that it withholds from them, more than in the case of a prospective tax, authority to distribute the increased tax burden in the light of experience and in conformity with accepted notions of the requirements of equal protection; or that in view of well established legislative practice, both state and national, taxpayers can justly assert surprise or complain of arbitrary action in the retroactive apportionment of tax burdens to income at the first opportunity after knowledge of the nature and amount of the income is available.

Id. at 149-150, 59 S.Ct. at 127.

[6] *See Untermyer,* 276 U.S. at 440, 48 S.Ct. at 353; *Blodgett,* 275 U.S. at 142, 48 S.Ct. at 105; *Nichols v. Coolidge,* 274 U.S. 531, 47 S.Ct. 710, 71 L.Ed. 1184 (1927).

In cases decided subsequently to Welch and the *Nichols-Blodgett-Untermyer* triology, the Court has drawn a clearer distinction between the retroactive imposition of a wholly new tax and a retroactive change in the base or rate of an existing tax. *See, e.g., Hemme,* 476 U.S. at 568, 106 S.Ct. at 2077; *United States v. Darusmont,* 449 U.S. 292, 299, 101 S.Ct. 549, 553, 66 L.Ed.2d 513 (1981).[7] In *Darusmont,* the Court considered a challenge to the retroactive application of a minimum tax provision which increased the tax due from the sale of a taxpayers' home which had occurred before the provision was enacted. After stating that "[t]he proposed increase in rate had been under

[7] This court and our sister circuits also have recognized the distinction between a retroactive change in existing tax law and the retroactive imposition of a wholly new tax, thereby limiting *Nichols, Blodgett,* and *Untermyer* to their facts. *See, e.g., Wiggins v. Commissioner,* 904 F.2d 311, 314 (5th Cir.1990) (upholding retroactive exclusion of investment tax credit recapture when calculating an alternative minimum tax); *Estate of Ekins v. Commissioner,* 797 F.2d 481, 484 (7th Cir.1986) (upholding the retroactive repeal of an estate tax exclusion for life insurance policies); *Fein v. United States,* 730 F.2d 1211, 1213 (8th Cir.), *cert. denied,* 469 U.S. 858, 105 S.Ct. 188, 83 L.Ed.2d 121 (1984) (same); *Estate of Ceppi v. Commissioner,* 698 F.2d 17, 21 (1st Cir.1983), *cert. denied,* 462 U.S. 1120, 103 S.Ct. 3088, 77 L.Ed.2d 1350 (1983) (upholding the retroactive repeal of an estate tax exclusion); *Westwick v. Commissioner,* 636 F.2d 291, 292 (10th Cir.1980) (retroactive changes in the minimum tax upheld in spite of detrimental reliance); *First National Bank in Dallas v. United States,* 420 F.2d 725, 730 n. 8, 190 Ct.Cl. 400 (1970) (interest equalization tax on foreign stock acquisitions may be retroactively applied), *cert. denied,* 398 U.S. 950, 90 S.Ct. 1868, 26 L.Ed.2d 289 (1970); *Sidney v. Commissioner,* 273 F.2d 928, 932 (2d Cir. 1960) (upholding retroactive taxation of gains realized from collapsible corporations).

public discussion for almost a year before its enactment" and that taxpayers were therefore in no position to claim surprise, the Court held that taxpayers' " 'new tax' argument is answered completely by the fact that the 1976 amendments to the minimum tax did not create a new tax." 449 U.S. at 299-300, 101 S.Ct. at 553. Similarly, in *Hemme,* the trustee of a taxpayer's estate challenged the retroactive application of a transitional rule bridging the gap between new and old regimes for federal taxation of gifts and estates. Applying the "harsh and oppressive" impact standard introduced in *Welch,* the Court "considered the nature of the tax and the circumstances in which it [was] laid. . . . " 476 U.S. at 568-69, 106 S.Ct. at 2078. The Court, without determining whether the provision at issue constituted retroactive taxation, held that "the provision represents a fair judgment by Congress that does not deprive appellees of anything to which they can assert a constitutional right." *Id.* at 571, 106 S.Ct. at 2079.

The change in tax law at issue in the case before us – the retroactive amendment to (and limitation of) a deduction created under the Tax Act of 1986 – cannot be characterized as a retroactive imposition of a wholly new tax. The estate tax was in place before section 2057 was introduced, and the amendment at issue simply limited the deduction provided under 2057, thereby restoring the pre-section 2057 status quo. To determine whether the retroactive amendment of section 2057 constitutes a change in tax law "so harsh and oppressive as to transgress the constitutional limitation[,]"[8] we must carefully

[8] *Hemme,* 476 U.S. at 568-69, 106 S.Ct. at 2078, *quoting Welch,* 305 U.S. at 147, 59 S.Ct. at 125.

consider the nature of the tax and the facts before us. *Hemme*, 476 U.S. at 568-69, 106 S.Ct. at 2078; *cf. Wiggins*, 904 F.2d at 316 (when retroactive legislation is challenged on due process grounds, a case-by-case analysis is required).[9]

Evaluating the government's retroactive amendment of section 2057 in the context of the facts before us, we conclude that the government did not inflict a "harsh and oppressive" change in tax law upon Paglin's estate. First, Notice 87-13 was formally published on January 25, 1987 – nearly a month *before* Ferman entered into the series of transactions at issue in this case. This fact distinguishes the case before us from the Ninth Circuit's opinion in *Carlton v. United States*, 972 F.2d 1051 (9th Cir.1992). Specifically, although *Carlton* also involved an executor's reliance on section 2057, the executor in that case entered the transaction at issue nearly one month *before* the IRS issued Notice 87-13. In reaching its conclusion that, as applied to Carlton's transaction, Congress' amendment to section 2057 violated the Due Process Clause, the Ninth Circuit was careful to distinguish the district court opinion in the instant case and to clarify that its "conclusion would likely be entirely different if Carlton had engaged in his transaction after January 5, 1987." *Id.* at 1062, *citing Ferman*, 790 F.Supp. at 656.

[9] In *Wiggins*, this court held that a retroactive amendment establishing an investment tax credit recapture constituted a correction rather than a new tax. 904 F.2d at 314. Specifically, we stated that "[t]he legislative history of the 1984 amendment indicates that this was not a new tax, but a correction necessary to effectuate Congress' intent in enacting [the Tax Equity and Fiscal Responsibility Act of 1982]." *Id.*

Although Notice 87-13 did not carry the authority of binding law, it did notify taxpayers of the possibility that section 2057 would be amended, how section 2057 might be amended, and the fact that there was risk associated with entering into transactions solely out of reliance upon section 2057. To hold that Notice 87-13 had no such effect would be to invite taxpayers to use such notices – which, as is established in the record, are issued by the IRS to inform Congress of its errors in drafting tax legislation – to locate Congress' mistakes and exploit them before they are corrected. Moreover, although one month may not constitute abundant notice, Ferman and her attorneys had every reason to remain observant for signs of change to section 2057. Specifically, although the transactions at issue cost the decedent's estate $49,057.50 in the form of deductions given to the ALZA ESOP, these transactions, in the absence of an amendment to section 2057, subjected the estate to a relatively low amount of risk and reduced its taxable amount by $466,046.25, or twenty-five percent. The result was a $177,362.03 reduction in federal estate tax. Although it is indisputable that section 2057 was passed to encourage the growth of ESOPs, the transactions at issue brought about an immediate benefit to the estate – and cost to the federal government through lost tax revenue – that was nearly four times greater than the deductions received by the ALZA ESOP.[10] Accordingly,

[10] As stated by Judge Norris in his dissent to the *Carlton* majority opinion,

> [T]he statute on its face offered a benefit that appeared "too good to be true." Admittedly, a number of laws provide tax incentives to encourage the growth of ESOPs, in some cases subsidizing third parties for facilitating the transfer of employer

we conclude that Notice 87-13 reasonably forewarned Ferman and her attorneys of Congress' amendment to section 2057. *See Milliken v. United States*, 283 U.S. 15, 21-24, 51 S.Ct. 324, 327, 75 L.Ed. 809 (1931) (upholding a retroactive gift tax where the donor was forewarned of the possibility of this tax); *Estate of Ekins v. Commissioner*, 797 F.2d 481, 484 (7th Cir.1986) ("[T]he application of a tax statute will not amount to a deprivation of property without due process of law if it meets two tests: the change is reasonably foreseeable and is only a fluctuation in the tax rate instead of a wholly new tax.").

Second, in amending section 2057, Congress was careful not to completely eliminate the deduction for taxpayers who relied upon it in their estate planning, as indicated by their (1) directly purchasing the securities before their deaths and (2) providing that these securities be allocated or held for future allocation in specified ways. *See* Pub.L. No. 100-203 § 10411, 101 Stat. 1330, 1330-432 (1987).[11] The transactions at issue in the case

securities to an ESOP. . . . But the outcome in this case . . . demonstrates that the deduction as drafted offered a subsidy of a wholly different magnitude from existing provisions. Congress could more providently have underwritten ESOP stock purchases directly from the U.S. Treasury without bringing in estate executors as middlemen!

972 F.2d at 1066.

[11] Section 10411(d) provides that:

(1) *In general*. – For purposes of this section, the proceeds of a sale of employer securities by an executor to an employee stock ownership plan or an eligible worker-owned cooperative shall not be treated as qualified proceeds from a qualified sale unless –

before us, rather than being part of Paglin's estate planning, were entered into after his death solely to take advantage of the deduction offered under section 2057.

When regulating economic activity, Congress generally enjoys wide latitude to legislate retroactively. *See Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729, 104 S.Ct. 2709, 2717-18, 81 L.Ed.2d 601 (1984);[12] *see also supra* note 5 (equating the standards of review for the retroactive application of statutes in and outside of the tax context). Moreover, the Supreme Court observed long ago that "[n]o more essential or important power has been conferred upon the Congress [than the power to collect taxes and raise revenues,] and the presumption that an Act of Congress is valid applies with added force

(A) the decedent directly owned the securities immediately before death, and

(B) after the sale, the employer securities –

(i) are allocated to participants, or

(ii) are held for future allocation in connection with

(I) an exempt loan under the rules of section 4975, or

(II) a transfer of assets under the rules of section 4980(c)(3).

[12] In *Pension*, the Court explained that:

the strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively. Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. . . .

467 U.S. at 729, 104 S.Ct. at 2717-18.

and weight to a levy of public revenue." *United States v. Jacobs*, 306 U.S. 363, 370, 59 S.Ct. 551, 555, 83 L.Ed. 763 (1939) (footnote omitted). Although Congress acted retroactively when amending section 2057, it was merely correcting a substantial error[13] publicly acknowledged through Notice 87-13 just three months after that error was made. Proposed legislation confirming the position taken by the IRS in Notice 87-13 was introduced into Congress the following month. And, at the time section 2057 was actually amended (just one week after Ferman filed a refund claim with the IRS for $177,362.03), the deduction had been in existence for just a little more than one year. *See Wiggins*, 904 F.2d at 315 (in upholding a corrective tax statute applied retroactively, stating that "[w]here legislation is curative, retroactive application may be constitutional despite a long period of retroactivity"); *cf. United States v. Hudson*, 299 U.S. 498, 500, 57 S.Ct. 309, 310, 81 L.Ed. 370 (1937) ("[I]t long has been the practice of Congress to make [income tax statutes] . . . retroactive for relatively short periods so as to include profits from transactions consummated while the statute was in process of enactment. . . . ") (citations omitted). Having analyzed the effect of Congress' retroactive amendment to section 2057 in the context of the facts before us, we conclude that limiting the scope of section

[13] Congress anticipated that the revenue loss resulting from the passage of section 2057 would be approximately $300 million. Because section 2057 was not specifically limited to instances where the decedent owned the employer securities at the time of his or her death, the potential revenue loss resulting from 2057 as originally drafted was estimated at $7 billion. *See* 133 Cong.Rec. H845 (daily ed. Feb. 26, 1987).

2057 to exclude the transactions at issue in this case does not constitute a change in tax law "so harsh and oppressive as to transgress the constitutional limitation." *Hemme*, 476 U.S. at 568-69, 106 S.Ct. at 2078; *Welch*, 305 U.S. at 147, 59 S.Ct. at 125.

III. CONCLUSION

For the foregoing reasons, we AFFIRM the district court's grant of summary judgment in favor of the government.